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2d Session

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FIRST MONETARY POLICY REPORT FOR 1986

FROM THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

UNITED STATES SENATE

NINETY-NINTH CONGRESS

SECOND SESSION

A REPORT

together with

ADDITIONAL VIEWS

SUBMITTED PURSUANT TO PUBLIC LAW 95-523

APRIL 28, 1986.—Ordered to be printed.

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LETTER OF TRANSMITTAL

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC, April 28, 1986.

Hon. GEORGE BUSH,
President of the U.S. Senate,
Washington, DC.

DEAR MR. PRESIDENT: Transmitted herewith is the First Monetary Policy Report for 1986 on the Conduct of Monetary Policy, pursuant to Public Law 95–523 and oversight hearing held on February 20, 1986.

Sincerely yours,

JAKE GARN, *Chairman.*

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FIRST MONETARY POLICY REPORT FOR 1986

APRIL 28, 1986.—Ordered to be printed

Mr. GARN, from the Committee on Banking, Housing, and Urban Affairs, submitted the following

REPORT

together with

ADDITIONAL VIEWS

[Submitted pursuant to Public Law 95-523]

FIRST MONETARY POLICY REPORT FOR 1986

On February 19, 1986, the Committee on Banking, Housing, and Urban Affairs received this year's first "Monetary Policy Report to Congress Pursuant to the Full Employment and Balanced Growth Act of 1978" (Public Law 95-523) from the Board of Governors of the Federal Reserve System.

On February 20, 1986, Federal Reserve Board Chairman Paul A. Volcker, testified before the Banking Committee on the conduct of monetary policy during the second half of 1985 and on the Federal Reserve's monetary policy objectives for 1986.

Statements for the record also were received from Beryl W. Sprinkel, Chairman of the Council of Economic Advisers; from John H. Makin, Director of Fiscal Policy Studies at the American Enterprise Institute; and from economists A. James Meigs and Jerry L. Jordan of First Interstate Bancorp.

MONETARY AGGREGATES IN 1985

Table I shows the target growth ranges for M1, M2 and M3 and the "monitoring" range for debt from the fourth quarter of 1984 through the fourth quarter of 1985 adopted by Federal Open Market Committee [FOMC] in February of last year.

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TABLE I.—1985 GROWTH RANGES

[In percent]

Aggregate	Growth range
M1	4.0 to 7.0
M2	6.0 to 9.0
M3	6.0 to 9.5
Debt	9.0 to 12.0

During the first half of 1985, growth in the broader aggregates was within or only slightly above the target and monitoring ranges. Growth in M1, on the other hand, surged in May and June. The result was an average annual growth rate of 12.2 percent in the narrow aggregate over the 6 month period.

When Chairman Volcker appeared before the Banking Committee in July of last year, he reported that, given the sluggishness in the economy at the time, the FOMC had decided not to seek to bring M1 growth back within the target range adopted in February. Instead, the Fed Chairman announced that the base for targeting M1 growth would be raised from its average size during 1984's fourth quarter to its average size during 1985's second quarter, and he set forth a widened target growth range of 3 to 8 percent.

After the midyear monetary policy hearing, however, M1 continued to grow at a rate that exceeded the upper boundary of its new higher and wider target range. From the second through the fourth quarters of 1985, M1 registered a 12.7-percent annual growth rate.

Table II contrasts all the monetary and credit aggregates' actual growth rates during 1985 with the target and monitoring ranges announced by the Federal Reserve.

TABLE II.—1985 ACTUAL VERSUS FED RANGES

[In percent]

Aggregate	Growth ranges	Actual growth
M1	3.0 to 8.0 [1]	[1] 12.7
M2	6.0 to 9.0	8.6
M3	6.0 to 9.5	7.4
Debt	9.0 to 12.0	13.5

[1] 1985.2 through 1985.4.

For the year as a whole, M1 velocity declined by 5½ percent. Chairman Volcker told the Committee that the Federal Reserve's research "strongly indicates that much of the unexpected decline in M1 velocity was a response to the sharp reduction in interest rates late in 1984." Lower interest rates reduce the opportunity cost of holding M1 balances.

The Fed Chairman, in explaining the decline in measured velocity, also emphasized the effects of the decline in inflation and of deposit rate deregulation on the public's desire to hold money balances.

In a written response to a question from Chairman Garn, Mr. Volcker summarized recent monetary developments:

> * * * in 1985 * * * incoming information about economic activity and prices suggested that, in light of strong demands for liquidity and associated declines in velocity, rapid growth of M1 above its ranges would not have inflationary consequences, and indeed was needed to foster satisfactory performance of the economy * * *

At the Banking Committee's hearing, Senator Gramm expressed support for the Federal Reserve's conduct of monetary policy since last spring: "As I look at the monetary policy of the Federal Reserve Bank in the last 9 months I think it is the right policy."

Senator Proxmire disagreed: "I have been very concerned about what I think was the explosive growth of the money supply last year."

Chairman Volcker responded to such concerns by telling the Committee that:

> * * * the judgment of the Federal Open Market Committee as the year developed was that the rather strong restrictive action that would have been necessary to maintain M1 within its targeted range was not justified in the light of the different signals conveyed by the much more restrained growth in M2 and M3, the slower growth in overall economic activity, the margins of capacity that remained, and the continuing progress toward price stability. For much of the year, the dollar remained high, and that fact was another strong signal that monetary policy was not unduly liberal.

Senator Heinz agreed that the Fed should not be bound, at least in the short term, to rigid constraints on growth in the aggregates:

> * * * Chairman Volcker describes the conduct of monetary policy as a day-to-day, week-to-week job. That is reassuring because it tells me that the Federal Reserve stands ready to make the necessary adjustments in policy and practice to deal with adverse developments.

MONETARY AGGREGATES IN 1986

Chairman Volcker announced at the February 1986 Banking Committee hearing that no effort would be made this year to offset the bulge in M1 that occurred during 1985. For the year ahead once again the target and monitoring ranges for the money and credit aggregates will use their average size in the fourth quarter of last year as a base.

The Fed Chairman told the Committee that the FOMC's 1986 target growth ranges for M1 and M2 would remain unchanged, that the upper boundary for the M3 target range would be raised one-half percentage point, and that both the upper and lower boundaries of the M3 monitoring range would be raised by 1 percentage point.

In a written response to a question from Chairman Garn, however, Mr. Volcker emphasized that the Fed:

> * * * (does) not aim at precise growth targets from quarter to quarter or even year to year, partly because that is

not reasonably feasible with the tools at our command and the lags involved, and also because other considerations (including prices) bear upon the *sustainability* of growth.

Jim Meigs and Jerry Jordan told the Committee, however, that:

> Frequent large departures from announced monetary targets and reversals of direction, such as those seen in recent years, damage the credibility of the monetary authorities, increase uncertainty in financial markets, and increase the costs of reducing inflation.

Table III contrasts the 1986 growth ranges for the monetary and credit aggregates with their 1985 ranges.

TABLE III.—1986 VERSUS 1985 GROWTH RANGES

[Percent change, fourth quarter to fourth quarter]

Aggregate	1986 growth range	1985 growth range
M1	3 to 8	3 to 8 [1]
M2	6 to 9	6 to 9
M3	6 to 9	6 to 9.5
Debt	8 to 11	9 to 12

[1] Applied 1985.2 through 1985.4

Chairman Volcker told the Committee that in his judgment,

> * * * the present (economic) expansion—already longer than the postwar average for peacetime years—is not about to die from old age or sheer exhaustion. We don't have the pressures on capacity, the excess inventories, the accelerating costs and prices, or the rising interest rates that have typically presaged cyclical downturns in the past.

The Fed's "Monetary Policy Report" emphasized that for M1,

> * * * the range was set on the assumption that there would not be a large drop in velocity, such as occurred in 1985.

The Report went on to say that,

> * * * The (FOMC) Committee felt that its monetary objectives were consistent with expectations for continued growth in output, further reductions in unemployment, and muted inflation in 1986 * * * their expectations center on real GNP growth of 3 to 3½ percent and on inflation in the 3 to 4 percent range.

John Makin cautioned the Committee on the consequences of a resumption of velocity growth:

> * * * barring another sharp drop in inflationary expectations, at some time in the next year or two, velocity growth may revert back toward its postwar trend level of 3 percent. In the case of M1 velocity, such a shift would represent a massive swing from −6 percent growth to a +3 percent growth per year. If such a swing occurred during

1986, zero M1 growth would be sufficient to accommodate nominal growth of 9 percent, or a combination of 4 percent in real growth and 5 percent inflation.

ANALYSIS

Banking Committee Chairman Garn's opening statement at the monetary policy hearing pointed to the difficulties associated with charting monetary policy in the immediate future:

> Last year the narrowly defined money supply grew at about 12 percent. Historical experience would suggest that such rapid money growth would need to be slowed to avoid a reacceleration of inflation.
>
> Historical experience, however, also would suggest that efforts to slow such rapid money growth can first lead to a slowing of real economic growth.
>
> Oil price declines as well are complicating monetary policy. Do the oil price declines reduce the threat of a resurgence of inflation and give the Fed more leeway to stimulate the economy or, alternatively, do the oil price declines have the same impact as a tax cut and lessen the need for monetary stimulus?
>
> Gramm-Rudman-Hollings raises yet more questions for monetary policy. Is there a need for monetary stimulus to offset the reduction in fiscal stimulus implicit in reduced Federal deficits and, if so, do the relatively long lags in the impact of monetary policy mean that the Fed must undertake stimulation before the deficit cutting measures are agreed upon?
>
> Finally, the decline in the value of the dollar on foreign exchange markets raises additional questions for monetary policy. When will this decline stimulate domestic production for both export and domestic consumption? Will the channeling of more domestic demand into domestic consumption lead to a resumption in the growth of monetary velocity?

Chairman Sprinkel told the Committee that:

> The administration's long-term objective for monetary policy continues to be a gradual reduction in the inflation rate until price stability is firmly established * * *
>
> The objective of price stability can best be achieved by a gradual and predictable reduction in monetary growth* * *
>
> * * * it is difficult to justify an indefinite continuation of the rapid M1 growth that occurred in 1985. Given the lessons we have all learned about the pernicious consequences of inflation, some slowdown in monetary growth is called for in the period ahead. Yet the slowdown should not be abrupt, since such action would likely disrupt real economic activity in the near term. Accordingly, a gradual steady deceleration of monetary growth seems most appropriate at this time.

OIL PRICES AND INTEREST RATES

Senator Heinz questioned Chairman Volcker on whether faster money growth might not be possible in light of the impact of lower oil prices on inflationary pressures, and the Senator suggested that lower interest rates might help restore productivity growth.

> * * * productivity growth has been zero. That carries with it the suggestion perhaps that the very high real interest rates that we have may make it too costly or unprofitable to get any increases in productivity.
>
> * * * doesn't that suggest that we should pursue a monetary policy that is more expansive and aimed at lowering interest rates, both real and nominal * * *
>
> Particularly as there is additional deflationary assistance from lowered oil prices * * * shouldn't the Fed pursue a more growth oriented monetary policy?

Senator D'Amato joined Senator Heinz in linking the decline in oil prices to interest rates. The Senator from New York argued that developments on the energy front gave the Federal Reserve a "unique opportunity" to lower interest rates and, thereby, "put more Americans back to work." Senator D'Amato specifically suggested a cut in the discount rate.

On March 7, the discount rate was reduced from 7½ percent to 7 percent. On April 18 the discount rate was cut again to 6½ percent.

Chairman Sprinkel took issue with the suggestion that lower oil prices should lead to an easing of monetary policy:

> * * * the decline in oil prices is a decline in a relative price. As such it is a market signal indicating that current oil supply exceeds demand. An easing of monetary policy would obfuscate that market signal and thereby inhibit the functioning of market clearing forces.
>
> * * * oil price declines will foster increased real GNP growth and lowered measured inflation in the near term * * *
>
> The Federal Reserve can take advantage of this temporary, one-time fall in prices to promote a steady deceleration in monetary growth and thereby improve the prospects that inflation and expectations of inflation will be completely eliminated and price stability firmly established.

Senator Sasser questioned Chairman Volcker on whether he could not make a contribution to solving the budget deficit by lowering interest rates:

> (The Office of Management and Budget) estimates that every 1 point drop in interest rates would reduce the deficit by $5.1 billion. Now you can't cut spending from where you sit and you can't raise taxes from where you sit. But do you see yourself having a role in deficit reduction through the third option, and that might be cutting interest rates?

Chairman Volcker responded by saying that he would "love to see" lower interest rates, but that they would have to be "consistent with balanced economic growth and keeping control over inflation." In particular the Chairman warned of the "danger" that attempting to reduce interest rates "artificially" would lead to higher rates.

Senator Heinz pointed out that actual declines in prices are causing serious problems for agriculture and certain industrial sectors. Senator Cranston raised the question of whether the concern should not be over "deflation in contrast to inflation."

GRAMM-RUDMAN-HOLLINGS

Senator Gramm told Chairman Volcker that an "expansive" monetary policy would be appropriate during the implementation of Gramm-Rudman-Hollings:

> We have begun a process here in the Congress aimed at transferring $200 billion of resources from the Government to the private sector, and in order to facilitate that transfer obviously we need an expansive monetary policy with declining interest rates, first nominal and then real.

Senator Mattingly specifically asked Chairman Volcker if the Fed would be "accommodating in order to prevent dislocation and the possibility of recession" as the budget deficit is cut to $144 billion in fiscal 1987.

Chairman Volcker suggested that the oil price decline lessened the need for monetary policy to seek to offset the contractionary effect of deficit reductions:

> * * * the effect (of the oil price declines) is to release real purchasing power and cash flow to American consumers and oil-consuming businesses. The potential addition to real consumer income should work in the direction of offsetting the effects on purchasing power that some have foreseen in the full implementation of the deficit reduction program called for by the Gramm-Rudman-Hollings legislation over the course of this year.

Dr. Meigs and Dr. Jordan told the Committee that:

> Any reduction in growth of total national employment and output that might result from a reduction in Federal expenditures would be more than made up by increases of employment and output in the private sector within 1 year. Therefore, it would be neither necessary nor desirable for the Federal Reserve to cushion the effects of deficit reduction through an easing of monetary policy.

In response to a direct question for the record from Senator Gorton as to whether "fine tuning" of monetary policy could be used to offset any contractionary effects of Gramm-Rudman-Hollings, Chairman Volcker responded that:

> (He did) not believe monetary policy can be "fine tuned" to offset the effects of one particular factor affecting the economy * * * In any event, the economic impact of

> Gramm-Rudman-Hollings is subject to substantial uncertainties, including the effect of court rulings on its implementation and the extent of offsetting increases in private spending as the drop in Government credit demands reduces pressures on interest rates and frees savings to be channeled to private investment.

Moreover, Mr. Volcker stressed to Senator Mattingly that:

> * * * the prospect of deficit reduction itself yields the positive result of helping to relieve the stresses and imbalances that have continued to plague our economy and represent a threat to the continuity of expansion.

Chairman Sprinkel also argued against adopting a more expansive monetary policy to offset the impact of scheduled fiscal deficit reductions:

> Fears that reductions in Government spending will cause an economic slowdown are unjustified for several reasons. First, (Gramm-Rudman-Hollings) targets can be met primarily by holding down the growth of real Government spending rather than cutting its level. In fact, the only significant cut in real Government spending is equivalent to about 0.5 percent of real GNP and occurs in fiscal year 1987. Six times in the past 35 years real spending cuts of this approximate relative magnitude have been made without evidence that they led to recession. Second, the required spending cuts will occur at a time when economic activity is likely to be relatively strong. Third, as long as the Federal Reserve maintains steady, predictable monetary growth, no serious or protracted macroeconomic disturbances should be expected from reducing the budget deficit.

VALUE OF THE DOLLAR

The value of the dollar peaked in February 1985 and then began to decline. In September the Finance Ministers and central bank Governors of France, West Germany, Japan, the United Kingdom, and the United States (the Group of Five or G–5) met and agreed that "some further orderly appreciation of the main non-dollar currencies against the dollar (would be) desirable."

Overall, the trade-weighted foreign exchange value of the dollar declined by nearly 25 percent between February and the end of 1985. Such a decline over time will tend to stimulate U.S. exports and increase the competitiveness of domestic producers vis-a-vis imports, but the Fed's "Monetary Policy Report" cautioned that:

> The response of U.S. industry, as well as of foreign producers, to the decline in the dollar will take place only over time and will depend on a number of factors, such as the extent to which it is believed the exchange rate change is "permanent" and on the strategies firms pursue with respect to the potential tradeoff between profit margin and market share.

The Fed Chairman also noted that:

> * * * improvement in our trade balance for the next year or longer is in large part dependent not on depreciation of our currency but on greater growth by our trading partners. More competitive pricing is of limited value when foreign markets are not growing strongly, and when producers abroad do not themselves have expanding, profitable markets at home.

Senator Heinz pointed out that "there are uncertain prospects that Japan and Germany will assume a leadership role * * * necessary to draw world trade into better balance and to help troubled debtors earn essential foreign exchange.

In a written response to a question from Chairman Garn, Mr. Volcker reiterated that:

> (His) public statements for more than a year have, in fact, consistently suggested the need for more "home grown" expansion in key foreign countries and raised the question of whether that did not justify some changes in policy and policy emphasis.

Senator Proxmire questioned Chairman Volcker as to whether, in efforts to reduce the U.S. trade deficit, "it would be very helpful if the dollar declined somewhat more." The Fed Chairman agreed that a lower dollar would help the trade deficit over time, but he warned of the dangers from an excessive or too rapid decline.

Dr. Meigs and Dr. Jordan told the Committee that:

> The monetary authorities of a country can try to stabilize the country's domestic price level, or they can try to stabilize its exchange rate. They cannot do both at the same time. Therefore, a policy of trying to reduce the dollar's value in terms of other currencies would mean accepting a higher inflation rate in the United States. Other countries have understood this for a long time, and so they generally consider a falling exchange rate to be inflationary.

Senator Riegle pressed Chairman Volcker on the dangers of a "free fall" in the value of the dollar, and the Fed Chairman said he thought that the extent of the dollar's decline could be approaching a "danger zone." Those dangers, as outlined in Chairman Volcker's formal statement, are inflationary pressures and loss of investor confidence in the dollar:

> * * * sharp depreciation in the external value of a currency carries pervasive inflationary threats.
>
> No doubt, some depreciation in the dollar, after the rapid run up, could be absorbed without a sharp or immediate impact on domestic prices. But we cannot afford to be complacent. Inevitably, prospects for balance in our internal capital markets—and therefore prospects for interest rates—remain for the time being heavily dependent on the willingness of foreigners to place huge amounts of funds in dollars and on the incentives for Americans to employ their money at home. In essence, the financing of both our current account deficit and our internal capital

> needs—so long as the Government deficit remains so high—is dependent on an historically high net capital inflow. Clearly, the *orderly* balancing of our demands for funds with supply in those circumstances requires continued confidence in our economy.

Senator Proxmire agreed with the concern over the inflationary consequences of declines in the value of the dollar:

> * * * there is no question that it is a tough, tough problem to fight inflation at any time. The latest concern of course is the dollar. There are many reasons why all of us would like to see the dollar continue to decline. It would certainly benefit many industries in our States and would provide, at least in the short run, more jobs. But I think the inflation problem is so serious that we have to be concerned about it.

Senator Gorton questioned the extent to which oil price declines would offset the inflationary effects of the fall in the dollar's value. Chairman Volcker's response focused on the relative timing of the two conflicting effects on inflation:

> Lower oil prices are likely to begin to affect consumer prices fairly quickly, over the next few months. In contrast, the fall in the dollar, which has been taking place for 12 months now, has only just begun to show up in higher import prices. The relative timing of these effects suggests that the recent decline in oil prices is likely to contribute to a continued favorable performance of prices over the course of this year. However, as the effects of the dollar decline are passed through increasingly into import prices, inflation could begin to pick up.

Senator Heinz stated his belief that "the exchange rate * * * needs to be a very important focus of U.S. monetary policy." The Senator cautioned, however, that the economic consequences of exchange rate movements can be difficult to predict:

> * * * back in 1977, 1978, and 1979 when Tony Solomon was Under Secretary of the Treasury he reported to us again and again that the weight of economic analysis and projections indicated that whatever problems there might be with the fall of the dollar, they were going to be infinitesimal and virtually immeasurable.
>
> Those projections were wrong. There were heavy costs to the economy, as there have been costs to key sectors due to the record high of the dollar more recently.

Regarding the relationship between monetary policy and exchange rate policy, Chairman Volcker told Senator Gorton that:

> In policy implementation we have made an effort to adapt certain policy instruments, such as the discount rate, in light of conditions in exchange markets and policy actions abroad as well as underlying economic and financial conditions here.

Senator Heinz questioned the need for change in the international monetary system, and Chairman Volcker responded that:

> * * * while (he did) not have a blueprint for international monetary reform, we ought to be prepared to examine various ways to achieve greater exchange-rate stability.

Senator Mattingly pointed to exchange rate volatility and questioned whether additional steps should be taken to increase stability. In particular the Senator pointed to exchange rate "target zones" as a way to enhance stability.

Chairman Volcker told Senator Mattingly that:

> We ought to be willing to examine these or other possibilities for achieving greater exchange-rate stability. The effects of exchange rates on our economy are too important to be ignored in policymaking, and exchange-market developments have increasingly been taken into account in the formulation of U.S. monetary policy.

On the issue of alterations to the international monetary system, Chairman Volcker told Senator Riegle that:

> We have had enough experience with the distorting effects of extreme exchange-rate volatility to justify a reexamination of the functioning of the international monetary system. I share the concern about the operation of the international monetary system, but one should not underestimate the complexity of the task of achieving intellectual and operational consensus about modifying the current international monetary arrangements.

With regard to the use of monetary policy to influence the exchange rate, Chairman Sprinkel told the Committee that:

> The impact of intervention and the sustainability of its impact depend critically upon whether the intervention is sterilized or unsterilized * * * sterilized intervention (intervention that does not affect domestic money supplies) has little, if any, long-run effect on nominal and, more importantly for affecting trade flows, real exchange rates. Unsterilized intervention (intervention that does affect domestic money supplies) is tantamount to conducting monetary policy in foreign exchange markets * * * Commitment of monetary policy to the control of exchange rates, however, interferes with its use for other important policy objectives * * *

Chairman Sprinkel reminded the Committee that:

> It is important to understand the relationship between the G–5 agreement in September 1985 and monetary policy. The G–5 agreement was not simply an agreement to intervene cooperatively to force down the value of the dollar. It was a recognition that the excess of domestic investment over domestic saving (i.e., the current account deficit) in the United States is mirrored by the opposite condition in the rest of the world. Consequently, the agree-

ment recognized that policy changes across countries, not just in the United States, are essential to correct external imbalances.

In a question for the record, Chairman Garn asked Mr. Volcker to expand on an indication in his written statement that one of the reasons for recent declines in measured velocity has been that domestic demand has been growing faster than domestic output.

Mr. Volcker responded that, in his view:

> * * * the more rapid growth in domestic demand than in output—the counterpart to our burgeoning trade deficit last year—probably contributed to the measured decline in GNP velocity in 1985. Such a divergence in growth rates would contribute to a decline in measured velocity to the extent that demands for money and credit are related to domestic spending as well as to domestic output and income, which is conventionally used to calculate velocity * * * (However) only rarely would I expect domestic demand and domestic output to diverge so widely as to have any measureable effect on velocity. For instance, even with the recent sharp decline in the dollar, the trade balance is likely to improve only moderately this year.

CONCLUSIONS

Pursuant to the requirement in the Full Employment and Balanced Growth Act for a report to the Senate by the Committee on Banking, Housing, and Urban Affairs stating its views and recommendations regarding the Federal Reserve's monetary policy report; the Committee finds:

(1) Evidence to date indicates that the 5½ percent decline in M1 velocity during 1985 was a consequence of increased demand for liquidity as lower interest rates, lower inflation, and deposit rate deregulation lowered the opportunity cost of holding money balances. The continued above-target growth in the M1 aggregate during the latter half of the year apparently was attributable to this decline in the velocity.

Should velocity stop declining and return to its postwar growth trend, however, severe inflationary pressures would develop unless the growth rates of the monetary and credit aggregates were slowed from last year's levels. The preponderance of historical evidence still points to the conclusion that long-term price stability will depend on a gradual reduction in monetary growth rates.

Nevertheless, given the uniqueness of the recent period of declining velocity and the difficulty of predicting in advance when changes in the demand for money will occur, the Committee recognizes that the Federal Reserve will need flexibility in the implementation of monetary policy during the months ahead.

(2) Recent declines in the price of oil raise questions for monetary policy in 1986. Measured inflation clearly will be held down by the fall in oil prices, and this could lessen the immedi-

ate concern over the inflationary consequences of somewhat faster money growth designed to push down interest rates.

At the same time, there are questions as to whether faster money growth would be the appropriate policy response. The oil price decline, itself, puts downward pressure on interest rates and frees purchasing power for use elsewhere in the economy.

(3) Reductions in Federal deficits mandated by Gramm-Rudman-Hollings pose additional questions for monetary policy. Fiscal stimulus to the economy clearly would be reduced by the scheduled budget cuts, and this could create the opportunity for a more accommodative monetary policy to help the private sector use the real resources released by the Federal Government.

The private sector, however, already is being aided in this task by the stimulative effect of the decline in oil prices and deficit reduction itself should relieve pressure on interest rates and reduce imbalances in the economy. Moreover, the fiscal change is not large relative to the size of the economy, and the unpredictability of lag time for the economic impact of policy changes leads to difficulties in seeking to offset alterations in fiscal policy with compensating adjustments in monetary policy.

(4) Finally, the decline in the value of the dollar on foreign exchange markets must be taken into consideration in the implementation of monetary policy. The dollar's decline, together with stronger economic growth on the part of our trading partners, will help reduce the U.S. trade and current account deficits. But if domestic monetary policy were so expansionary as to cause too sharp of a decline in the dollar's value, there could be high costs to the U.S. economy, particularly from renewed inflationary pressures and loss of investor confidence.

Clear lessons which can be drawn from recent exchange rate experience are that excessive exchange rate volatility can have significant costs to the economy and that coordination of monetary policy initiatives with our major trading partners can yield important economic benefits.

ADDITIONAL VIEWS OF MESSRS. PROXMIRE, RIEGLE, SARBANES, DODD, AND SASSER

We have not always agreed with every monetary policy action taken by the Federal Reserve over the last several years. Some of us have questioned the need for the sharp reduction in money growth in 1981 that helped to bring on the 1982 recession. Similarly, there have been questions as to whether monetary policy could have contributed more to the pace of the recovery since 1982. But putting these questions aside, there is no doubt that the Federal Reserve has, by and large, been successful in achieving what it set out to do—and that is to purge the economy of rampant inflation. And with inflation being stopped in its tracks, we are experiencing one of the longest economic recoveries since the end of World War II.

These accomplishments have been achieved not because of but in spite of the economic policies of the Reagan administration whose top economic officials profess to see no relationship between budget deficits and interest rates. Certainly the sustained runup in the price of the dollar, the collapse of our export markets for manufactured and agricultural goods, and the conversion of the United States to a net debtor nation can be linked directly to the massive budget deficits brought about by the fiscal policies of the Reagan administration.

In the meantime, the Federal Reserve has earned a well deserved credibility within the business and financial community, both at home and abroad, for its responsible monetary policies. This credibility has paid enormous dividends in the way of lowered inflationary expectations.

Given the critical need to maintain confidence in the Federal Reserve's commitment to a responsible monetary policy, we are concerned about recent reports that four members of the Board may have attempted to wrest leadership away from Chairman Volcker by voting for a decrease in the discount rate over the Chairman's objections. As we understand the debate, the issue was not over the need for a reduction (which was supported by all the Governors) but over the timing of the reduction and whether it would be coordinated with the central banks of West Germany and Japan. Rightly or wrongly, the press has widely characterized the vote not as a substantive disagreement over policy but as an attempt to challenge the Chairman's leadership.

We would be the last to argue that the Governors of the Federal Reserve Board should rubberstamp the views of its Chairman, especially when major policy issues are on the table. Nonetheless, on narrower issues involving timing and coordination with other central banks, we believe the Chairman's views should be given considerable weight. After all, the Chairman is the principal representative of the Federal Reserve in public and among foreign central banks. If the Chairman is to be second-guessed by other Gover-

nors less experienced in international matters, confidence in the Federal Reserve can only be weakened. Political maneuvering should have no place in the deliberations of the Federal Reserve System.

WILLIAM PROXMIRE.
DON RIEGLE.
PAUL SARBANES.
CHRISTOPHER J. DODD.
JIM SASSER.

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